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# Global financial crisis: The tasks ahead

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A safe path of global balance and stability will be a lot easier if global liquidity growth is tied to the growth of real global output in some mechanism that injects and withdraws liquidity counter-cyclically as global real output growth slackens or paces up. The IMF (reformed with appropriately rebalanced voting rights and quotas for member economies) can be mandated to craft and administer the tying mechanism, in a new role somewhat as the apex global monetary agency, writes Salehuddin Ahmed

Though, there are signs of recovery of the world economy after five years of the global financial crisis, the tasks ahead for full recovery are quite daunting. The scenario of recovery gives an uneven picture with some developed countries showing signs of good recovery while others sticking to a weak status. In comparison with the performance of other regions, Asia's recovery has been the fastest and strong with China and India leading the group. Within each region (for the developed and the developing regions), the pace of recovery is uneven and varies across countries. The table below gives the comparative picture of growth rates (per cent change):

| | 2009 | 2010 | 2013 | 2015 |
|---|---|---|---|---|
| World | 0.5-1.0 | 1.5-2.5 | 3.3 | 3.8 |
| USA | -2.6 | 0.2 | 2.2 | 3.1 |
| Euro Zone | -3.2 | 0.1 | -0.4 | 1.3 |
| Emerging Nations | 1.5-2.5 | 3.5-4.5 | 4.7 | 5.0 |
| China | | | 7.7 | 7.1 |
| India | | | 5.0 | 6.4 |
| Japan | | | 1.5 | 0.8 |
| Bangladesh | | | 6.1 | 6.2 |

The global financial and economic crisis started in 2007 in the aftermath of the housing sector bubble burst coupled with aggressive lending practices in the US sub-prime mortgage market and lax regulation of the financial sector. To start with, these developments affected the companies holding mortgage-backed securities and credit derivatives. The early signs of the crisis were evident in 2007; but the financial crisis developed into a full blown global recession in late 2008 turned serious by continuous deepening and widening of the crisis. The recession created shockwaves throughout the global financial system and the global economy, and the advanced economies were affected most. The governments in these countries are bracing their financial sector and the real economy by stepping up various policy measures including injection of huge sums of money for bailing out the ailing financial institutions and other industries. What is worse is that the recession is not showing any sign of abatement even in 2014.

The crisis essentially originated from the US imbalances was exported to the rest of the world, over the last couple of decades or so, in the form of persistent current account deficits. The position of US dollar as the dominant global reserve currency enables US to pursue lax macroeconomic policies indefinitely, with its deficits financed externally by economies having surpluses. Not since the beating down of US inflation in the 1980s by US Fed under Paul Volcker at substantial pain of a domestic recession has the US opted again for domestic adjustments to correct imbalances; nor unlike the EU, has the US committed itself unequivocally to pursuing balanced policies (fiscal accounts were in balance in the Clinton era but private sector deficit unrestrained, and in the subsequent Bush era deficits of both public and private sectors ran amok).

In the lax US monetary and fiscal policy regime the surfeit of cheap liquidity surged in several aberrant directions chasing higher returns; into speculation creating commodity and asset price bubbles (the incipient US house price bubble at the turn of the century actually eased the pains from the dot com bubble burst), into equity buybacks with reckless leveraging (improving return on equity but worsening the fragility of corporate finance), into loans to borrowers of dubious credit and securities backed thereby, into derivatives of inscrutable complexity concealing the riskiness of the underlying assets. Close global integration transmitted these trends of the US financial markets and institutions quickly to the other open economies, including those pursuing balanced policies. Also, the laxities of US monetary policies immediately and automatically surfaced in the economies with currencies pegged to US dollar, including the Middle Eastern oil exporters. The surging wealth from price bubbles in commodities and assets flowed not into combating global poverty, environmental degradation or climate change; but largely into hedonism of private jets, yachts, mansions and other indulgences including such whimsical, fanciful pursuits as competition in mega scale fairytale-like construction projects, artificial islets curved in the Gulf with coastlines alien to known laws of hydrodynamics, mega dollar artworks like golden lamb and Kate Moss gold statue. Now the whole fantasy structure faces collapse as popping price bubbles triggered chains of debt default, paralyzing markets with freeze up of fresh lending to refinance maturing debts.

Small economies like Bangladesh are however by no means invulnerable to fallouts from prolonged global downturns or to negative spillovers of policies of large economies, and therefore have strong stake in global stability. In forums like G-20 they need to argue forcefully for the same high priority to stability as to recovery; and also for stability action agenda going beyond addressing symptoms (lapses in risk managements, inadequacies of regulation and supervision) to addressing the underlying cause (lax policies allowing unbridled liquidity expansion, incubating bubbles).

A safe path to global balance and stability will be a lot easier if global liquidity growth is tied to the growth of real global output in some mechanism that injects and withdraws liquidity counter-cyclically as global real output growth slackens or paces up. The IMF (reformed with appropriately rebalanced voting rights and quotas for member economies) can be mandated to craft and administer the tying mechanism, in a new role somewhat as the apex global monetary agency.

Consensus building for such a new mechanism (in broad likeness of gold standard, with real global output substituting for gold) may be arduous, all the more reason for kicking off the consultation processes at the soonest possible.

Significant gain in global financial stability can be expected also from reforms limiting excessive leverage in corporate finance. In the current crisis the high fragility brought about by reckless substitution of equity with debt precipitated extended chains of debt defaults, paralyzing financial markets across major economies. A corporate generally favours debt over equity because debt servicing costs are tax deductible while income on equity is subject to taxation. However, in downturns, debt burden deepens a firm's financial distress, even inviting demise, as made amply evident by the current global financial crisis.

The Bank for International Settlement (BIS) in Basel, Switzerland for some years is engaged in developing global norms of capital adequacy for banks and financial institutions. BIS can also be mandated to develop global norms of debt equity balance and sound practices in corporate financing, limiting tendencies of excessive leveraging. To this end, tax break to some extent on income from equity, narrowing the gap in relative attractiveness of debt and equity as financing option, may also be well worth considering.

The Nobel Prize winner in economics Jean Tirole has pointed out to the needs of realigning regulations for the markets and in another work related to banks the authors (Dewatripont, Rochet and Tirole) have argued for reforming bank regulations to avoid future financial crisis. It's high time we give serious thought on the issues raised in this article.

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